Supreme Court of the United States

October Term, ~~1948~~. 1949

No. 742. 55

IN THE MATTER

OF

CALTON CRESCENT, INC.,

Debtor.

MANUFACTURERS TRUST COMPANY, as Trustee under an Indenture made by the Debtor under date of September 27, 1933, and individually,

Petitioner,

AGAINST

REGINE BECKER, EMILY K. BECKER and WALTER A. FRIBOURG,

Respondents.

Respondents' Brief in Opposition to Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit.

DAVID W. KAHN,
Counsel for Respondents,
Office & P. O. Address,
120 Broadway,
Borough of Manhattan,
City of New York.

LODER APPEAL PRESS, INC., 65-67 Duane St., N. Y. C., Tel. WOrth-2-0689

INDEX.

PAGE

Comment on Petitioner's Summary Statement 2
Summary of the Findings Upon Which the Decisions of the Lower Courts Were Based 6
The Grounds Upon Which the Decisions of the Courts Below Rested 11
Summary of Argument 14

ARGUMENT:

I.—The reasons assigned by petitioner for an allowance of a writ of certiorari are untenable. Petitioner's assertions are incorrect that the decision rendered in the court below runs counter to long established and uniformly applied principles and that it conflicts with decisions in the Sixth, Seventh and Tenth Circuits 15

II.—There are no cases, Federal or State, holding that purchases of debt securities of a going concern by members of directors' families or friends—or even by directors themselves—constitutes a violation of fiduciary duty 20

III.—The cases relied upon by petitioner as establishing a diversity of opinion in the various circuits are clearly distinguishable and none of them is in point 23

CONCLUSION 29

CASES CITED.

Anderson v. Blood, 152 N. Y. 285 18
Claude Neon Lights, Inc. v. Federal Electric Company, Inc., 250 App. Div. 510 21
Equitable Holding Corporation v. Woody, 63 Fed. (2d) 751 (1933) 5

PAGE

Glenwood Mfg. Co. v. Syme, 109 Wis. 355 ...... 21, 22, 23
Hauben v. Morris, 255 App. Div. 35 21
In re Franklin Bldg. Co., 83 Fed. Supp. 263 (D. C. E. D. Wis. 1948) 18
In re Indiana Flooring Co., 53 Fed. (2d) 263 30
In re Jersey Materials Co., 50 Fed. Supp. 428 ..... 25, 26
In Re Lorraine Castle Apartments Bldg. Corp., 149 Fed. (2) 55 (C. C. A. 7—1945) certiorari denied 326 U. S. p. 728 18
In re Los Angeles Lumber Products Co., Ltd., 46 Fed. Supp. 77 25
In re McCrory Stores Corporation, 12 Fed. Supp. 267 .... 21, 26
In re Norcor Manufacturing Co., 109 Fed. (2d) 407, C. C. A. 7 (1940) 29
In re Philadelphia & Western Railway, 64 Fed. Supp. 738-741 .... 18, 26
In re Van Sweringen Company, 119 Fed. (2d) 231.. 26, 28
In re Vulcan & Reiter Co., 80 Fed. Supp. 286 (1948) 5
Jackson v. Smith, 254 U. S. 586-589 17
McIntyre v. Ajax Mining Co., 28 Utah, 162 21
Monroe v. Scofield, 135 Fed. (2d) 725, C. C. A. 10 (1943) 29
Nassau Works v. Brightwood Co., 265 U. S. 269 (1924) 5
Okin v. Securities and Exchange Commission, 137 Fed. (2d) 398 18
Pepper v. Litton, 308 U. S. 295 (1939) 24, 28
Prudence Realization Co. v. Geist, 316 U. S. 89 .. 13
Ripperberger v. Allyn, et al., 25 Fed. Supp. 554 ... 21
Securities and Exchange Commission v. Chenery, 318 U. S. 80 12
Seymour v. The Spring Forest Cemetery Association, et al., 144 N. Y. 333 .... 21, 22, 23
Wendt v. Fischer, 243 N. Y. 439 24

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Respondents.

Respondents' Brief in Opposition to Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit.

An application for a Writ of Certiorari is made by the Manufacturers Trust Company, individually and as Indenture Trustee, to correct an alleged error in a determination of the United States Court of Appeals for the Second Circuit which affirmed a decision of the United

States District Court for the Southern District of New York, overruling objections made by the said petitioner to the claims filed by the three respondents, Regine Becker, Emily K. Becker and Walter A. Fribourg in the above entitled proceeding. The order of the District Court, in turn, affirmed an order made by Hon. Peter B. Olney, Referee in Bankruptcy, after a protracted trial held before him on the said objections of the petitioner, during the course of which over 500 pages of testimony was taken and almost 100 exhibits were offered in evidence.

The printed record on appeal filed in the lower Court, which is here submitted by the petitioner in support of its application for certiorari, is by no means the complete record of this litigation.* Under the rules of the Court of Appeals for the Second Circuit, each party prints only such portion of the record as it desires, but the entire record in typewritten form is filed with the Clerk of the Court of Appeals where it may be referred to by the Court. Thus, it will not be possible in this brief to refer the Court to such portions of the record as are contained in the stenographic transcript but not in the printed appendixes. However, all statements made in this brief are fully supported by the testimony and exhibits found in the complete typewritten transcript filed in the Court below.

Comment on Petitioner's Summary Statement.

The summary statement of the matters involved, appearing at pages 3 to 6 of petitioner's brief, is so incomplete that it by no means conveys an accurate or fair

*References to petitioner's portion of this printed record will be designated in this brief as "A". References to respondents' portion of the printed record will be referred to as "R. A." References to testimony contained in the typewritten record in the Court below (but not printed in the appendices) will be referred to as "S. M." Petitioner's Exhibits are referred to as "Obj. Ex." and respondents' exhibits are referred to as "Resp. Exs."

picture of the events and transactions which form the subject matter of this litigation, nor, indeed, of the precise question of law presented. A much more complete and accurate review of the evidence and of the questions of law presented will be found in Referee Olney's findings and opinion printed at pages 86 to 101 of petitioner's appendix in the Court below, and in the opinion of Judge Swan in the Court of Appeals, printed at pages 9 to 22 of the petitioner's appendix to its reply brief in the Court below.

Anyone reading petitioner's brief to this Court in support of its application for a Writ of Certiorari would get the impression that what is here involved is the acquisition by directors of an insolvent corporation—pursuant to a campaign deliberately organized for that purpose—of a large batch of debt securities from public investors at a small fraction of their value under circumstances which establish failure of fiduciary duty, overreaching, and failure to disclose material facts. Nothing could be further from the truth.

It is significant that, upon the argument in the Court below and also in its brief to this Court, petitioner abandoned all charges of overreaching and failure to disclose, which constituted the basis of its objections to the claims of the respondents. Now, seemingly for the first time, petitioner relies for its objections to the claims of the respondents upon the sole ground that they were relatives or friends of the directors and that since directors themselves could not have purchased these securities and proved them for the full face amount (because the purchases were made while the debtor was insolvent) the respondents are under a similar disability because of the relationship described.

Having thus stated the ground of objection upon which it now relies, petitioner goes on to urge that certiorari should be granted by this Court because the decision of

the Court below "runs counter to long established and uniformly applied principles with respect to the fiduciary duties and obligations of directors of an insolvent corporation"; and that it has heretofore been uniformly held that directors may not traffic in the debt securities of their insolvent corporation and thereafter in bankruptcy enforce their claims upon such securities beyond the amount which they actually paid for them. We shall later show in this answering brief (1) that petitioner is entirely mistaken in its belief that the decision of the Court below runs counter to long established and uniformly applied principles and that such decision has never been approved in any Federal Court; (2) that, on the contrary, such doctrine has been approved by numerous Federal Courts as well as by the Courts of New York State, and (3) and that there is no decision in any Federal Court which supports the extreme and highly impractical and unrealistic view here pressed by petitioner.

As the Court will note from petitioner's brief, the Securities and Exchange Commission filed a brief *amicus curiae* in the lower Court. After the within brief of the respondents had been completed, the Commission served a memorandum in support of petitioner's application, repeating all of the contentions urged in the lower Court. There is one point in this memorandum of the Commission, that we think should be commented upon. The Commission claims that the questions which have arisen in the instant case are of particular importance in Chapter X proceedings, in which it has a statutory interest. The proceeding in the lower Court, however, was one brought under Chapter XI, in which the Commission has no interest or standing. Chapter XI contains no provisions for limitation proceedings, such as are found in §212 of Chapter X. Moreover, there is no authority for the proposition that limitation proceedings will lie in a Chapter XI case. Since Chapter XI is nothing but a substitution for

the old type of composition under former §12 of the Bankruptcy Act, it is extremely questionable whether, in such a proceeding, one alleged creditor may oppose the claims of others (*Nassau Works* v. *Brightwood Co.*, 265 U. S. 269 [1924], at page 271; *Equitable Holding Corporation* v. *Woody*, 63 Fed. [2d] 751 [1933], *In re Vulcan & Reiter Co.* 80 Fed. Supp. 286 [1948]).

In any event, however, the sole basis of the Commission's contention is that purchases of securities of a corporation by directors or by members of their families or friends should not be permitted after insolvency because then "potential conflict cannot be avoided since the acquisition of such securities may lead directors to postpone institution of proceedings under the Bankruptcy Act." The Commission acknowledges that a similar conflict of interest could exist in some situations even where the corporation is solvent. But the Commission, no more than petitioner, even attempts to meet the issue in the instant case as to how it could be determined when insolvency first occurred. As we later show, on pages 10 and 11 of this brief, on the basis of petitioner's own arguments on the insolvency issue, the debtor corporation was insolvent from the very moment it came into existence. None the less—and paradoxical as this may seem—the debtor corporation continued to function for a period of thirteen years in this supposed insolvent condition and paid all of its current liabilities and mortgage indebtedness in full.

Manifestly, the questions of law here involved are not abstract questions. Whether the Courts below correctly decided these legal questions depends upon the facts on which the legal determination was made. Therefore, before we proceed with a discussion of the petitioner's arguments, it will be useful to set out some of the more important facts embraced in the findings of Referee Olney, which findings, as already pointed out, have been affirmed by the District Court and the Court of Appeals.

Summary of the Findings Upon Which the Decisions of the Lower Courts Were Based.

1. None of the respondents ever was an officer or director of the debtor. Two of the respondents, Regine Becker and Emily K. Becker, were the mother and wife respectively of Sanford Becker, who was an officer and director. The respondent Fribourg had no relationship or connection with Becker, other than that he had desk space in his office (A. 27-28).

2. None of the three respondents ever had the slightest connection with the management or operation of the affairs of the debtor corporation (pp. 20-21—appendix to appellant's reply brief).

3. The moneys used to acquire the debt securities were the moneys of the respondents and none of the officers or directors of the debtor corporation had any financial interest in the purchases or participated therein in any way (pp. 20-21—appendix to appellant's reply brief).

4. All of the bonds acquired by the three respondents were purchased months and years before the parcel of real estate constituting debtor's sole asset was finally sold by the debtor—some of them as much as three years before such sale. Until such sale, no one could tell what the bonds would be worth on liquidation. None of these bonds was purchased after the filing of the petition for arrangement in the District Court or in contemplation of the filing of such petition, or at a time when the debtor corporation itself was able to buy or was in the market to purchase its own securities (A. 98).

5. The greater portion of the bonds were purchased by respondents directly from parties who were themselves officers and directors of the debtor corporation and

who had been such for a longer period than Norman and Sanford Becker, and all of whom approached the respondents with an offer to sell. One of these, Richard Kelly, the President and a Director of the debtor corporation, was a lawyer of vast experience and the counsel for one of the large savings banks in New York City (S. C. 477) who owned $8,250 of bonds; another Hays, owning $8,500 of bonds, was a member of the New York Stock Exchange; a third, Clay, was the financial adviser of the Young Women's Christian Association, which owned $7,550 of the bonds. Still another block amounting to $37,500 was acquired from the King Estate, represented by the law firm of Reynolds, Richards and McCutcheon, one of whose partners, Mr. Minor, was on the Board of Directors. That all of these officers and directors who sold their securities had full and complete knowledge of the affairs, operations and property of the debtor corporation, was overwhelmingly established (see Resp. Exs. 7, 8, 9, 10, 11, 16, 17, 22, 23, 24, 25b, 25e and 29, pp. 57 to 91 of R. A.; see also Findings 44, 47, 50 and 51; A. pp. 95-97). Even petitioner concedes that these parties knew they were selling their bonds to the respondents.*

6. The remaining bonds (with the exception of 12 purchases totaling $15,750 face amount, made by the respondent Fribourg on the so-called Winter offer) were all acquired by purchase in the open market through various brokerage firms (Obj. Exs. 11, 12 and 13, pp. 75-76 A.). Included among the sellers were such experienced and well known security dealers as Goldwater & Co., Reily & Co., Shaskan & Co., Foster & Adams, Kissel, Kinnicutt & Co., and Sondheimer & Co. In every instance these brokerage firms sold as principals for their own account, as is the practice in the over-the-counter market (see Obj. Ex. 19).

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*As to these bonds so acquired from other directors and officers, all of the opinions in the Court below, including the dissenting opinion of Judge Hand, were to the effect that such purchases were in every respect lawful and proper and free from any attack by petitioner.

The so-called Winter offer, made more than two years before bankruptcy, under which the aforementioned $15,750 face amount of bonds was purchased, came about at the insistence of Mr. Kelly, debtor's president. When he agreed to sell his own bonds to respondent Fribourg, it was upon the understanding and condition that the same offer should be made available to all other bondholders (see opinion of Judge Swan, p. 15, appendix to appellant's reply brief).

7. Had it not been for the respondents and the honorable and generous aid which they extended to the debtor corporation, there would have been no return whatever for creditors in this case.

As Judge Swan pointed out in his opinion (see pp. 12-14, appendix to petitioner's reply brief) the debtor corporation stood in peril of imminent foreclosure of the first mortgage held by the Poughkeepsie Savings Bank in the amount of $162,000 in 1943. This was averted only by an advance of $15,000 by respondents (for which they received a second mortgage). Although every other bondholder of the debtor corporation was afforded an opportunity to participate in this second mortgage, no one saw fit to do so. With the $15,000 advanced by respondents, the arrears under the first mortgage of the Poughkeepsie Savings Bank were paid. Even after the second mortgage given to respondents went into default in 1943 and the respondents could have foreclosed their mortgage and wiped out all of the other debenture holders, they not only did not do so, but they advanced additional sums totaling $7,941.63 to meet taxes on the property. Thus the debtor corporation was able to retain the property until 1946, when it was sold for $300,000—sufficient to pay the debenture holders 41.63%. Judge Swan, reviewing these acts of the respondents said (see p. 14 appendix to appellant's reply brief):

> "There is no contention that the conduct of the appellees above recounted was 'inequitable'. It was obviously very beneficial to those debenture holders who retained and have proved their bonds in the arrangement proceeding. It forestalled foreclosure by the first mortgagee and enabled the debtor to retain its property until it could be sold for a price of $300,000. * * * No complaint is made as to the price at which the debtor sold, nor is it suggested that the debtor should have sold sooner at a lesser price or have postponed the sale in the hope of obtaining a better price."

In short, the record in this case reveals not only no wrongdoing, overreaching or inequitable conduct on the part of the respondents and the directors but, on the contrary, a highly commendable and beneficial course inuring greatly to the advantage of all the creditors, which has been commended by the Referee, the District Court and the Court of Appeals.

From the foregoing it will be evident that the petitioner's contention on this application is, and necessarily must be, that despite the admitted lack of any violation of fiduciary duty and, indeed, the highly commendable and beneficial conduct of the directors, neither these directors nor even members of their families or friends had the right to purchase, at a discount, the debt securities of the debtor corporation—no matter how long before bankruptcy such purchases were made and even though most of the purchases were made direct from other directors and officers of the debtor corporation.

Petitioner concedes on this application that the sole foundation for this extreme contention advanced by it is that, although the bonds in question were purchased months and years before bankruptcy, they were none the less purchased at a time when the debtor corporation was

insolvent in a bankruptcy sense. Petitioner's argument is that directors and members of their families can purchase debt securities of their corporation while the corporation is solvent, but that such purchases are forbidden the moment the corporation becomes technically insolvent—even though the corporation continues on in business for many years after such insolvency occurs.

Applied to the facts in the instant case, petitioner's theory leads to strange results.

(a) Petitioner's claim of bankruptcy insolvency is based upon the fact that when debtor's sole asset—Calton Court Apartment building in New Rochelle—was sold in 1946, the price realized was less than the face amount of the debtor's liabilities then outstanding, represented by the issue of income bonds maturing in 1953. Petitioner then assumes, as a matter of course, that the debtor's sole asset was never worth more than the amount realized on the sale and hence that the debtor corporation was at all times insolvent throughout the whole period of its existence, to wit: 1933-1946. The fact that the City of New Rochelle assessed the debtor's property for $421,630 (A. p. 92), which was in excess of all of the debtor's liabilities, and that the cost of the property was greatly in excess of that amount, is completely disregarded. Only the final sales price received in 1946 is considered by petitioner. Manifestly, until the debtor's property was actually sold in 1946, no one could say with any certainty just what it would bring and whether this price would be as much as the assessed value, or less or more. The record clearly shows that prior to 1945 there was no market for this property or any other similar property in New Rochelle (R. A., p. 51). The only means, therefore, of fixing a valuation on such property during the period of time here involved would have been by expert appraisal. There could be no better expert appraisal than the assess-

ment made by the City of New Rochelle and, indeed, petitioner submitted none other.

On petitioner's strange line of reasoning, there was never a time when directors or members of their families or friends would have had the right to acquire the debt securities of the debtor corporation—since such debtor was at all times insolvent—and if any of them chose to go into the market and buy such securities, in the hope of a better day, they must be deemed to have done so in contemplation of a subsequent bankruptcy.

(b) The fact that during all of these 13 years the debtor was able to operate as a going concern; retain ownership of its property and pay in full all taxes, interest on mortgages and operating expenses—which alone must have exceeded $600,000 in amount, is totally ignored.* But as Judge Goddard pointed out in his opinion in the District Court (A. 121-122) even in those cases where purchases made by directors were held to be subject to the limitation rule, the corporations involved were not going concerns, but were corporations which either had already gone into bankruptcy or were contemplating doing so. Manifestly, no other rule would be tolerable or practical. We shall argue this point more fully at a later part of this brief.

The Grounds Upon Which the Decisions of the Courts Below Rested.

Petitioner asserts under this heading that the Referee, the District Court, and the Court of Appeals, although all reaching the conclusion that petitioner's objections

*The necessity for the filing of the petition for arrangement by the debtor corporation in this case was occasioned by its inability to pay in full the issue of income debentures totaling $254,450, issued in 1933, which did not mature until September 27, 1953 and on which no interest was payable unless earned. The debtor corporation paid in full all of its other indebtedness, including mortgages, interest on mortgages, taxes and operating expenses.

should be overruled, yet disagreed between themselves as to the theory or ground upon which that should be done. This assertion is not correct.

Both Referee Olney and Judge Goddard in the District Court held that even a director of a going corporation could acquire unmatured obligations of his corporation at a discount, although at such time the corporation may have been insolvent, provided the debtor had not set up any special fund to pay the said obligations; that no special liquidation had been ordered through the institution of receivership or kindred proceedings; that the debtor was not in the field to settle its own obligations, and that in acquiring such obligations the directors did not act unfairly to their corporation nor become involved in competition with it; and that the directors were not guilty of overreaching by unfairly using their special knowledge in dealing with those from whom they acquired the obligations. Such holding was supported with the citation of numerous cases—both Federal and New York State (see A. pp. 100; 120-122). Judge Goddard in his opinion emphasized that the rule of law applied by Referee Olney was undoubtedly the correct rule under the numerous decisions handed down by the Courts of New York State with respect to securities acquired by directors of a corporation that was "a going concern" (A. 120). There is thus no warrant for petitioner's claim that Judge Goddard's reasoning and conclusions differed from those of Referee Olney. Furthermore, it is again incorrect to say, as petitioner does, that Referee Olney relied principally upon the decision of this Court in *Securities and Exchange Commission* v. *Chenery*, 318 U. S. 80. That case was mentioned by the Referee merely for purposes of comparison but was not utilized as an authority.

In the majority opinion in the Court of Appeals, Judge Swan, just as Judge Goddard had done, declared that the

Federal Bankruptcy Law and not State law governs distribution of a bankrupt's assets to its creditors, citing *Prudence Realization Co.* v. *Geist*, 316 U. S. 89. Judge Swan, however, then went on to point out that even on the basis of the Federal decisions on this subject, as declared by this Court and other Federal Courts, the conduct of the respondents here complained of was not such that the Bankruptcy Court would have been justified in penalizing them by reducing their claims to the amounts paid therefor.

Thus, it will be seen that there has been no divergence of view between Referee Olney, Judge Goddard and Judge Swan. An examination of the opinions written by each clearly shows that though they considered the matter from various angles, each found the conclusion unavoidable that the respondents were entitled to prove their claims for the face amounts thereof, just as other creditors.

It is, of course, true that in his dissenting opinion in the Court below, Judge Learned Hand disagreed with his colleagues on the one question as to whether, under any circumstances, directors of a corporation who acquire securities of their corporation by purchase from others may, at a later date when the corporation becomes insolvent, prove their claims for the full amounts thereof. Judge Hand, while agreeing with Referee Olney, Judge Goddard, and Judges Swan and Chase "that the trustee's (petitioner's) case broke down so far as it rested upon the suppression of any specific information" or any other form of wrongdoing or inequitable conduct, yet advanced the view that while directors of a going corporation—even an insolvent one—should not be completely prohibited from buying the debt securities of their corporation, they should be permitted to do so only if when they made such purchases they had reasonable grounds for believing that their corporation had a good chance of effecting a

composition and going on with its business. Unless this was proved, it was Judge Hand's notion that the directors so purchasing the securities should not be permitted to make a profit on the purchase. He added, however, that he would not apply this rule to "any bonds bought by a director from a director", because "surely they stand on an equality." He also expressed doubt as to whether this rule should be applied when the purchases are not made by directors but only by members of their families.

At this point it is not necessary to make any comment upon Judge Hand's views, except to point out that, on the basis of his concession to the majority opinion of his Court, all that would remain in controversy in this case would be an utterly insignificant amount representing the profit on the few bonds that were acquired from persons who were not themselves directors and officers or Stock Exchange dealers in the securities.

Summary of Argument.

I.

The reasons assigned by petitioner for an allowance of a Writ of Certiorari are untenable. Petitioner's assertions are incorrect that the decision rendered in the Court below runs counter to long established and uniformly applied principles, and that it conflicts with decisions in the Sixth, Seventh and Tenth Circuits.

II.

There are no cases, Federal or State, holding that purchases of debt securities of a going concern by members of directors' families or friends—or even by directors themselves—constitutes a violation of fiduciary duty.

III.

The cases relied upon by petitioner as establishing a diversty of opinion in the various circuits are clearly distinguishable and none of them is in point.

ARGUMENT.

I.

The reasons assigned by petitioner for an allowance of a writ of certiorari are untenable. Petitioner's assertions are incorrect that the decision rendered in the court below runs counter to long established and uniformly applied principles and that it conflicts with decisions in the Sixth, Seventh and Tenth Circuits.

Petitioner at pages 9-14 of its brief, under the heading "Reasons Relied on for Allowance of Writ" seeks to create the impression that the decision rendered in the Court below runs counter to long established and uniformly applied principles with respect to the fiduciary duties and obligations of directors and is, therefore, erroneous; furthermore, that this decision directly conflicts with decisions of the Court of Appeals for the Sixth, Seventh and Tenth Circuits.

Both of these assertions, so made by petitioner, are completely incorrect.

The alleged claim of diversity of opinion will be dealt with under Point III of this brief. Here we deal with the other reasons urged by petitioner to support the present application for certiorari.

(a) The decisions of the Courts below in the instant case did not, as is here claimed by petitioner, break down or mitigate the standards of fiduciary duties and obligations of directors. This claim is completely untenable in the light of the conceded facts.

It has already been pointed out that this case did not deal with any acts of directors or other fiduciaries at all. The respondents now before the Court were at no time directors or officers of the debtor corporation nor in any way concerned with the management or operation of the debtor's business. The purchases were made with their own money and no director had any interest therein (see page 6 of this brief).

It is well settled, as we shall presently show, that purchases of securities made by members of the families, or friends, of directors, with their own funds and for their own benefit, do not fall in the same category as purchases made by directors. But in the instant case, the Courts below also considered the matter as though the various purchases had been made by the directors themselves, and there was unanimous opinion that even if the said purchases had been made by the directors for their own account, there would be no basis in fact or in law for penalizing them by limiting their claims,—this for the reason that there was not only a total absence of wrongdoing, misconduct, overreaching, misrepresentation or concealment, but, on the contrary, a course of action which greatly benefitted all the other creditors of the debtor corporation. Judge Swan, in the prevailing opinion in the Court below pointed out, in language of the utmost clarity, that even assuming the maximum of petitioner's contention, viz: that the Bankruptcy Court has power as a disciplinary measure to penalize directors or other fiduciaries for misconduct of any kind, no grounds for the exercise of such power existed in this case where, not alone was there no misconduct, but actual benefit in what the directors and the respondents did for the debtor corporation and its creditors.

A reading of the opinions of Referee Olney, Judge Goddard and Judge Swan will reveal that they sanctioned no relaxation of the long established and uniformly ap-

plied principles with respect to fiduciary duties and obligations of directors. Both Referee Olney and Judge Goddard pointed out in their opinions that even where directors are permitted to acquire securities of their corporation for their own account, they may only do so where they do not compete with their corporation nor resort to any overreaching by using their special knowledge (see A. pp. 100; 120-122). And Judge Swan's opinion, of course, affirms this same doctrine. What petitioner is really complaining about here is that the Courts below refused to adopt its arguments that the mere acquisition of the bonds by respondents—standing by itself—constituted a violation of fiduciary duty.

(b) There is ample authority for the proposition that even in those cases where directors are prohibited from making a personal profit themselves by purchasing the securities of their corporations, such ban does not necessarily extend to members of their families who make such purchases for their own account and with their own funds and who are guilty of no overreaching or wrongdoing. This particular subject is fully and adequately discussed in the opinion of Judge Swan at pages 19-21 of the appendix to appellant's reply brief. There Judge Swan points out that the rationale of the rule which forbids persons who knowingly confederate with a fiduciary in the breach of a trust from making any profit out of the transaction, is, as expressed in the case of *Jackson v. Smith*, 254 U. S. 586-589, that no one who knowingly joins a fiduciary in committing a wrong should be allowed to make a profit out of the transaction. Judge Swan goes on to say, however, that in the instant case even the directors were guilty of no breach of trust and, on the contrary, displayed only the most creditable and commendable conduct in the interests of all the creditors; that, therefore, there could be no possible basis for the claim

that the respondents confederated with the directors to bring about a breach of trust. Judge Swan further points out that in the instant case the respondents did nothing more than invest their moneys on the basis of advice given to them by one of the directors—advice which the respondents were free to follow or reject, and that these respondents were guilty of no improper conduct or overreaching of any character. In these circumstances, Judge Swan held that the rule of law expounded in the case of *In re Philadelphia & Western Railway*, 64 Fed. Supp. 738-741, should be applied, and there can be no doubt that the decision in that case adequately supports the result reached in the Courts below. But there are also other cases which support Judge Swan's conclusion on this point (*Anderson* v. *Blood*, 152 N. Y. 285; *Okin* v. *Securities and Exchange Commission*, 137 Fed. [2d] 398; *In Re Lorraine Castle Apartments Bldg. Corp.*, 149 Fed. (2) 55, [C. C. A. 7—1945]; certiorari denied 326 U. S. p. 728; *In re Franklin Building Co.*, 83 Fed. Supp. 263 [D. C. E. D. Wis. 1948]). Pertinent, too, is §16(b) of the Securities and Exchange Act of 1934, which expressly recognizes the right of directors to trade in securities of their own corporations but prevents them from keeping any short term profits on securities purchased and re-sold within a six months period. Even if this drastic rule were applicable in the instant situation, none of the purchases here involved would have been affected, since there never was any resale of the securities acquired and, in any event, all the purchases had been made more than six months before bankruptcy.

In the *Franklin Building Co.* case, *supra*, the precise question here involved was adjudicated, although in that case the proceeding in the District Court was one filed under Chapter X. The Trustee argued, as does the petitioner here, that certain members of the families of directors who had purchased securities with their own funds

could not prove their claims for more than the amounts paid, because they were affected by the same fiduciary duties and obligations as were the directors themselves. Judge Duffy, overruling this contention said (p. 267):

> "We must next consider whether the disabling rule hereinbefore stated should be extended to members of the family of William A. Schroeder and to Elizabeth Richter, whose husband, A. W. Richter, was an officer and director of the Franklin Building Company. I think the situation as to Mollie Schroeder, June Kuptz, and Elizabeth Richter (to the extent of $5,000) is clear. They were not in a fiduciary relationship. Their bonds were purchased with their own funds; there is no intimation in the evidence that such purchases were made as the agents of William A. Schroeder or A. W. Richter, respectively, or as a device or subterfuge to cover purchases by them. The Court of Appeals for the Seventh Circuit, in *Re Lorraine Castle Apartments Bldg. Corporation, Inc.*, 149 F. 2d 55, 57, held that Section 212 of the Bankruptcy Act does not apply to third parties, or to those who are under no fiduciary obligation. * * *"

In opposition to the cases above considered and those cited in the opinions in the Courts below, petitioner offers only the cases which we will discuss under Point III—none of which is in point and all of which, as will be shown, deal with cases where there has been affirmative wrongdoing, if not actual fraud. It is significant that petitioner failed to cite in the Courts below and fails to cite in its application to this Court, a single case adjudicating that, or any state of facts such as exists here, members of the family of a director may not, with their own money, purchase securities of the directors' corporation and retain any profit that may be earned.

II.

There are no cases, Federal or State, holding that purchases of debt securities of a going concern by members of directors' families or friends—or even by directors themselves—constitutes a violation of fiduciary duty.

As has already been pointed out, petitioner has not cited a single case—Federal or State—holding that purchases of debt securities of a going concern by members of directors' families or friends—or even by directors themselves—constitute a violation of fiduciary duty. The cases cited by petitioner, as will be shown under Point III, are all of an entirely different pattern. With few exceptions, they deal with instances of actual fraud, wrongdoing, or overreaching practiced by directors acting alone or in conspiracy with others. In none of such cases was the corporation involved a going concern.

On the other hand, the authorities supporting the right of directors and members of their families and friends to make purchases of the character here under discussion are legion. Judge Goddard pointed all this out in his opinion (A. 121-122), from which we quote the following excerpt:

> "However, these cases do not seem to cover a situation where the corporation, although insolvent in a bankruptcy sense, is still a 'going concern' for the mere fact that a corporation is insolvent does not dissolve the corporation and make the directors mere trustees of its assets if it is still a 'going concern.' *White, Potter & Paige Mfg. Co.* v. *Pettes Importing Co.,* 30 Fed. 864; *Contra Costa Water Co.* v. *City of Oakland,* 113 P. 668, 682, 159 Cal. 323; *Public Market Co. of Portland* v. *City of Portland,* 130 F. (2nd) 624, 646, 171 Or. 522; *Michigan Wolverine Student Co-op.* v. *Wm. Goodyear & Co.,* 22

N. W. 2nd, 884, 888, 314 Mich. 580. This distinction as to the duty of a director when the corporation, although insolvent is a going concern, was recognized in *Sanford Tool Co.* v. *Howe, Brown & Co.*, 157 U. S. 312; see *Asheville Lumber Co.* v. *Hyde*, 172 Fed. 730, 733.

In the case at bar these purchases were made when the corporation was a going concern and in later years even began to show an operating surplus * * *."

It is particularly significant in this case that the New York Courts, including the Court of Appeals, has on numerous occasions sustained the right even of directors to purchase debt securities of their corporation (where there is absent any element of wrongdoing or overreaching)—and this without regard to whether the corporation involved was solvent or insolvent. (*Seymour* v. *The Spring Forest Cemetery Association, et al.*, 144 N. Y. 333; *Claude Neon Lights, Inc.* v. *Federal Electric Company, Inc.*, 250 App. Div. 510; *Hauben* v. *Morris*, 255 App. Div. 35.) This same rule has been followed by Federal Courts and other State Courts (*Glenwood Mfg. Co.* v. *Syme*, 109 Wis. 355; *McIntyre* v. *Ajax Mining Co.*, 28 Utah 162; *Ripperberger* v. *Allyn, et al.*, 25 Fed. Supp. 554; *In re McCrory Stores Corporation*, 12 Fed. Supp. 267). It is, of course, true that petitioner has contended—and still contends—that none of the cases cited involved an insolvent corporation. That contention, however, is not correct. The *McCrory* case did involve an insolvent corporation, but Judge Patterson—who had also decided the *Ripperberger* case, *supra*—drew no distinction between purchases of securities of an insolvent corporation as contrasted with those of a solvent corporation and, on the contrary, he cited as authority for his view that "under ordinary conditions a director may purchase claims

against his corporation at a discount and enforce them for their full amount" the decisions in *Seymour v. The Spring Forest Cemetery Association, supra, Glenwood Manufacturing Co. v. Syme, supra.* This last mentioned case, too, involved purchases made by a president and director of an insolvent corporation, but the Court nevertheless refused to limit the claims. The decision in this last cited case contains very cogent reasoning which totally demolishes the artificial doctrine sought to be imposed here by petitioner.

It is significant that petitioner has constantly avoided and still avoids presenting any reasonable or workable formula from which it could be determined how and when, in the case of a going concern like the debtor, which managed to struggle through thirteen years of existence and pay all of its current obligations as well as its mortgage indebtedness, directors desiring to purchase the debtor's securities are to decide whether the corporation is solvent or insolvent. Are they to be required each time they wish to buy to obtain an appraisal of the debtor's property? When, as here, the debtor owns nothing but real estate which may not be sold for years to come and for which there is no ready market, how are they to make sure they do not transgress? Or are directors of such a realty corporation, whenever the immediate market value of its property seems to be less than its total indebtedness—and even though the larger part of such indebtedness does not mature for years to come—required to immediately plunge their corporation into some kind of an insolvency proceeding instead of trying to nurse it along towards a better day?

Judge Swan, discussing this aspect of the matter, pointed out that he could find no logical or practical reason for differentiating between the purchases of securities of an insolvent corporation as against a solvent one. He said (p. 18, appendix to appellant's reply brief):

> "It is not immediately apparent why insolvency should make a difference. It will cost the debtor no more whether the dividend which it may be able to pay creditors goes to the original holder of the debt or to a director-assignee."

This same reasoning was adopted by the Court of Appeals of New York State in the case of *Seymour v. Spring Forest Cemetery Association, supra,* and by the Supreme Court of Wisconsin in the case of *Glenwood Mfg. Co. v. Syme; supra.* Furthermore, it is certainly significant that thus far neither the Legislature of the State of New York nor the Congress of the United States has sensed the supposed potential danger which petitioner seems to think lurks in granting directors the right to purchase securities of their corporation after it becomes technically insolvent. It is reasonable to assume that had any such supposed potential danger existed, statutory provisions to prevent it would have long since been enacted. Where Congress found that, on the basis of actual experience, some prohibition was necessary, it did not hesitate to act (see §212 of Chapter X). But admittedly none of the acts proscribed in §212 exist in the instant case.

III.

The cases relied upon by petitioner as establishing a diversity of opinion in the various circuits are clearly distinguishable and none of them is in point.

The whole thesis of petitioner's argument, contained in pages 17-26 of its brief, is that it is an established violation of fiduciary duty for directors to traffic in the securities of their corporation, no matter how free the directors may be from wrongdoing or overreaching, and that the mere purchase of such a security from a co-director or in the open market is a legal and moral wrong

for which such director must be penalized; also that where, on the directors' advice or judgment, members of their families make such purchases, they, too, must be penalized, no matter how free from wrongdoing their acts may have been. The manifest fallacy of this thesis becomes readily apparent when it is noted that petitioner itself concedes the right of directors to buy debt securities where insolvency does not exist. Why a perfectly lawful and proper act should become unlawful and tainted with moral condemnation the moment the value of a corporation's assets temporarily falls below its liabilities—although the corporation continues on with its normal business for years to come—has not been explained. Why neither Congress nor any of the State Legislatures have recognized this imaginary evil and enacted legislation to prevent it has also not been explained. And why, particularly in this case, where the directors by their heroic and extraordinary devotion to duty saved the debtor corporation's property from complete loss in foreclosure and rendered possible the excellent result finally obtained, any penalty should be imposed not against the directors but against members of their families who never occupied any fiduciary relationship to the debtor corporation, has also not been explained.

It will be sufficient to say that none of the cases cited in petitioner's petition and brief supports the impractical, unworkable, artificial and unjust rule sought to be established.

Pepper v. *Litton*, 308 U. S. 295 (1939) dealt with the question as to whether claims obtained by the controlling stockholders of a bankrupt corporation were to be treated equally with claims of other creditors where the evidence revealed "a scheme to defraud creditors reminiscent of some of the evils with which 13 Eliz. c. 5 was designed to cope."

Wendt v. *Fischer*, 243 N. Y. 439, dealt with a gross violation of fiduciary duty by an agent who brought about

a sale of a piece of property to his own corporation without disclosing to the owner that he had any interest in this corporation. This case did not deal with any purchases of securities by directors and is completely irrelevant to any issue here presented.

In *Re Los Angeles Lumber Products Co., Ltd.*, 46 Fed. Supp. 77 (1941, D. C. S. C. Cal.) involved purchases of the debtor's securities by a director after the corporation had become insolvent and a bondholders' committee had been formed to function in the reorganization proceeding which was considered imminent and which did take place shortly thereafter. That fact alone distinguishes the case from the instant case, and Referee Olney has pointed this out very clearly in his opinion (A. p. 101). Moreover —and this is important—the decision of the Federal District Court in the *Los Angeles Lumber* case was based upon two California decisions cited by the Court at page 88, thus indicating that the Court was applying a rule of local application.

In the case of *In re Jersey Materials Co.*, 50 Fed. Supp. 428, one Schweyer, the President of the bankrupt company, learning that a first mortgage upon its property in the sum of $3,500 was for sale, arranged with one of his close friends, Connor, to pick it up for the sum of $1,600. This money was supplied by Schweyer himself. Judge Forman, in holding that Connor could not recover more than the amount paid for the mortgage said:

> "I am persuaded that Connor purchased the mortgage from the Greens with the intent that Schweyer should benefit thereby and that under such circumstances Connor should recover from the bankrupt estate no more than the sum of money paid by him for the mortgage, together with interest from the date he paid it."

The complete dissimilarity existing between the facts in this *Jersey Materials Company* case and the instant

case will be at once apparent. Here the three respondents purchased the bonds in question with their own money and the directors neither had nor retain any benefit or interest in the purchase. Unlike the *Jersey* case, they were not dummies for officers or directors engaged in a plan to freeze out one of the stockholders. Moreover, the purchase in the *Jersey* case was made when bankruptcy was not only in contemplation but imminent.

In the case of *Philadelphia & Western Ry. Co.*, 64 Fed. Supp. 738 (1946) a decision of the District Court for the Eastern District of Pennsylvania, Judge Kirkpatrick, as we have already pointed out in this brief, refused to limit the claims of J. Prescott Stoughton and Agnes C. McKernan, although the first named party was the father of Russell S. Stoughton, who was an officer of the debtor corporation, and the second named party was an officer of the Conway Corporation, which had a management contract with the debtor for the management of the debtor's business. The case, far from being an authority in support of petitioner's contentions, is really an authority in support of the respondents' position. So Judge Swan held (see pp. 20-21, appendix to appellant's reply brief).

The case of *In re McCrory Stores Corporation*, 12 Fed. Supp. 267, dealt with a purchase of landlord's claims. The purchaser's claim was limited to the amounts paid, under the scrutiny clause of §77-B (11 U. S. C. A. §207[b]), because of the violation on his part of fiduciary obligations. Judge Patterson, however, reaffirmed the rule that "under ordinary conditions, a director may purchase claims against his corporation at a discount and enforce them for their full amount".

In the case of *In re Van Sweringen Company*, 119 Fed. (2d) 231, which was a reorganization under §77-B, the debtor corporation had pledged virtually all of its assets with J. P. Morgan & Co. to secure loans exceeding $39,-000,000 in amount, for which promissory notes were given to the said pledgee. These notes went into default and

the Morgan Company gave notice that it would sell the collateral at auction. By that time, of course, the debtor corporation had completely ceased doing business as a going concern. The Van Sweringen Brothers, who were officers and directors, designing to acquire control of the pledged assets for themselves and to freeze out all of the creditors of the corporation, connived with two individuals named Ball and Tomlinson to form a corporation known as the Midamerica Corp. which would buy in these pledged assets at the auction sale at a ridiculously low price. This was successfully accomplished and then the Midamerica Corp. proceeded to file a claim in the reorganization proceeding for the face amount of the notes which it had acquired at the auction sale conducted by the pledgee, Morgan & Co. The grossly flagrant character of the transaction was marked by the fact that although the Midamerica Corp. had on its own books allocated only $1.00 of the price paid on the auction sale for the note of the debtor corporation in the amount of $8,177,-023.99 and had allocated only $887 as the cost of another note in the face amount of $13,787,000, and $2.00 as the cost of a still further note of the debtor's subsidiary, Cleveland Terminals Building Company, in the amount of $1,348,614.99, it nevertheless proceeded to file claims against the debtor corporation for the full face amount of these large obligations—and this notwithstanding the fact that it had already acquired at the sale all of the collateral security which was deposited to secure these obligations. This same Midamerica Corp., it developed, had agreed by contract to give the Van Sweringen Bros. a ten year option to acquire 55% of the stock in the Midamerica Corp. at cost, plus 5% interest, and also agreed to pay them a salary of $100,000 a year. The net result of the transaction, as the Court pointed out, was that without investing a penny the Van Sweringen Bros., who as officers and directors of the debtor corporation occupied a fiduciary relationship to their creditors, came out

of the affair with complete voting control of the Mid-america Corp. for ten years; a $100,000 annual salary, and an option to buy 55% of the stock of the Midamerica Corp. for $8,250.

This was a type of fraud which a Bankruptcy Court had full power to deal with not only under the provisions of Section 77-B, but also under the inherent power to prevent fraud recognized in *Pepper* v. *Litton*, 308 U. S. 295. The Court, citing the *Pepper* case as authority, pointed out that what the Midamerica Corp. did was "within the inhibited area of bargaining not conducted at arm's length as defined in *Pepper* v. *Litton*." The Court went on to say that it was apparent "that the cupidity of persons in a fiduciary position has caused them to serve themselves in preference to those whom it was their duty to serve."

In view of the clearly dissimilar facts existing in the case at bar, it is difficult to understand on what theory the decision in the *Van Sweringen* case can be regarded as a pertinent authority. That case but reaffirms the well settled doctrine that an officer of a corporation owing the highest degree of loyalty to his creditors, will not be permitted to personally profit by persuading others to join him in violating his fiduciary obligations, and that in such a situation the guilty party who aids in the violation of the duty owing by the fiduciary cannot profit from his confederation with the fiduciary. Contrast the situation in the *Van Sweringen* case with that in the instant case, where none of the directors joined in any purchase and, indeed, had no interest in the purchases; where what was purchased were obligations of the debtor corporation and not assets of the debtor's estate. Also to be recognized is the fact that the purchases in the *Van Sweringen* case were made after the corporation had ceased doing business and its assets were being sold under the hammer, whereas in the instant case all such purchases were made over a

period of years while the debtor corporation was a going concern conducting its normal business.

In the case of *In re Norcor Manufacturing Co.*, 109 Fed. (2d) 407, C. C. A. 7 (1940), the claims against the bankrupt corporation were purchased not only by Krueger, the principal stockholder and director, but also by his attorney Lehner, as well as by Lehner's wife. All these claims so purchased were then reassigned to a corporation whose board of directors were controlled by Krueger and Lehner. The claims were purchased after the bankrupt corporation had already confessed insolvency in the Court. The Circuit Court of Appeals held that Krueger occupied a fiduciary relation, as did his attorney Lehner, and that not only did they have no right to purchase claims in competition with the corporation, but that Lehner's purpose in acquiring the claims and transferring them to the new corporation was fraudulent.

In the case of *Monroe* v. *Scofield*, 135 Fed. (2d) 725, C. C. A. 10 (1943) Monroe, a director of the bankrupt corporation, after bankruptcy had intervened, went out and bought a judgment against the corporation held by one McClain for $200, though the face amount of the judgment was $732.60. The Court held that this Monroe could not do "unless by an order of the Court", or if otherwise "he has been shorn of all power in the corporate management and his trust relationship has been fully terminated."

In Conclusion.

It will be apparent from the foregoing review of the authorities relied upon by petitioner, that all of them fall within the well recognized exceptions referred to in the opinions in the Courts below. There is, thus, no basis for the claim made by petitioner that the decision here sought to be reviewed presents any new or novel doctrines dealing with obligations and duties of directors and fiduciaries—much less that such decisions of the lower Courts

create a diversity of view between the Second Circuit and the other Circuits which require this Court to settle the correct rule.

The opinions written by Referee Olney, Judge Goddard and Judge Swan correctly interpret the rule of law applying in the instant situation, according to well settled authority. Their decision was just and correct and it should not be disturbed.

Not one single creditor of the debtor corporation joined in the objections presented by the petitioner nor asked petitioner to file such objections. The petitioner, under the provisions of the indenture (App. Ex. 28) has no authority to appear or file any claim in the bankruptcy proceeding for the holders of the debtor's debenture bonds —much less to file any objections to the claims of other creditors (*In re Indiana Flooring Co.*, 53 Fed. [2d] 263, and cases cited on page 265). In its individual capacity the petitioner is an alleged creditor for only $1,587.50 covering fees claimed to have been earned as indenture trustee, but this claim is under objection and has not yet even been allowed by the Referee in Bankruptcy.

Were this a case where respondents, or even the directors involved, had committed an injury against any of the other debenture holders, there might be some explanation for the petitioner's objections, but, as was pointed out in all three opinions below, the reverse of that is the case. Here the directors not only greatly benefited the other debenture holders, but saved the debtor's property from total loss through foreclosure of the first mortgage. Not a single one of the debenture holders who sold his securities has complained. No wonder Judge Swan expressed his wonderment as to how or why anyone could, in such a case as this, ask for the imposition of penalties.

This litigation has now been pending for almost three years and all of the Courts which have heard the case have found a total lack of merit in petitioner's conten-

tions and arguments. Petitioner has failed to show any reason for being permitted to go on further with this litigation.

It is accordingly submitted that the petitioner's motion for the issuance of a Writ of Certiorari should be denied.

Respectfully submitted,

DAVID W. KAHN,
Counsel for Respondents,
Office & P. O. Address,
120 Broadway,
Borough of Manhattan,
City of New York.